ST 03-2
Tax Type: Sales Tax
Issue: Gross Receipts
Unreported/Underreported Receipts (Fraud Application)

STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS

THE DEPARTMENT OF REVENUE	)	Docket No. 01-ST-0000
OF THE STATE OF ILLINOIS	)	IBT No. 0000-0000
v.	)	NTL No. 00-000000000000000
JOHN DOE d/b/a	)	
ABC AUTO SALES,	)	John E. White,
Taxpayer	)	Administrative Law Judge

RECOMMENDATION FOR DISPOSITION

Appearances: Thomas Rueckert appeared for ABC Auto Sales; John Alshuler appeared for the Illinois Department of Revenue.

Synopsis:

This matter involves a Notice of Tax Liability ("NTL") the Illinois Department of Revenue ("Department") issued to a business, ABC Auto Sales ("ABC"), owned and operated by John Doe ("Doe"). The NTL assessed Retailers' Occupation Tax ("ROT") regarding the period from July 1, 1997 through and including August 1999.

The parties agreed that the issues to be resolved at hearing included the propriety of the Department's method to calculate taxable gross receipts, and the propriety of the Department's use, during its audit, of documents obtained during the execution of a search warrant for someone else. I have reviewed the evidence adduced at hearing, and I am including in this recommendation findings of fact and conclusions of law. I recommend the NTL be finalized as described here.

Findings of Fact:

1. ABC was a sole proprietorship operated by Doe that, during the audit period, engaged in the business of selling used automobiles. Department Ex. 1 (Department's Correction and/or Determination of Tax Due, top left-hand corner); Hearing Transcript ("Tr.") pp. 12-13 (testimony of Sammy Sagum ("Sagum"), the Department's auditor).

2. ABC discontinued business at the end of August 1999. Department Ex. 1.

3. Sagum conducted the Department's audit of Doe's business for the months of 7/1/97 through 8/31/00. Department Ex. 1; Tr. p. 12 (Sagum).

4. Sagum began the audit by meeting with Doe, at which time Sagum asked for and received from Doe certain books and records. Tr. p. 12 (Sagum).

5. The records Sagum obtained from Doe included: some "deal jackets," meaning a copy of the bill of sale and a copy of the return regarding that sale; bank statements; and cashed checks. Department Ex. 5, p. 2 (memo written by Sagum to his supervisor, dated May 10, 2001).

6. After reviewing those records, Sagum compared them with the data included on the transaction returns Doe filed regarding the period at issue, and determined that Doe's records were not complete. Tr. pp. 13-14 (Sagum).

7. Sagum also obtained some of Doe's books and records from an agent of the Department's Bureau of Criminal Investigation "(BCI"), and used them in his audit. Department Ex. 5, p. 2; Tr. p. 17 (Sagum). Those records were recovered by BCI agents when it executed a search warrant for, *inter alia*, business records while investigating another taxpayer that conducted business at the same location where Doe had previously conducted business. Department Ex. 5, p. 2.

8. Sagum performed a block sample of records regarding sales for a two consecutive month period. Department Ex. 3. He chose November and December 1998 as the block sample period because he had the most records available for those two months. Tr. pp. 15, 24 (Sagum).

9. When performing the block sample, Sagum mailed out questionnaires to the individuals who were named as purchasers on the transaction-by-transaction returns ABC filed during the sample period. Department Ex. 3. He received three responses to those mailings. *Id.*; Tr. pp. 14-17 (Sagum).

10. After reviewing the documents and materials obtained from BCI and from the responses to his block sample mailings, Sagum compared them with the returns filed regarding the audit period. *See* Department Ex. 4. He determined that, for those 33 transactions, taxpayer underreported the selling prices of the cars at a rate of 47.96%. Tr. p. 29 (Sagum). That is, he determined that Doe reported a selling price on the returns he filed for those 33 sales transactions that was only 47.96% of the selling price the purchasers agreed to pay for the vehicles they purchased from Doe. *See* Department Ex. 4 (35,115 ÷ 73,210 ≈ .4796). He then projected the underreporting rate he calculated for all months in the audit period. Tr. p. 18 (Sagum). Finally, he applied a 50% fraud penalty to the amount of the tax due. Tr. pp. 18-20 (Sagum); Department Ex. 1.

11. Doe told Sagum during interviews that when he sold a car, he usually received only the amount a purchaser gave him as a down payment, because purchasers tended not to make any further scheduled payments after the purchaser's down payment and Doe's physical transfer of an auto. Tr. p. 24 (Sagum). One of Doe's

purchasers made similar statements to Sagum regarding his purchase of a car from Doe. Tr. pp. 48-51 (Sagum).

Conclusions of Law:

The Department introduced the auditor's Correction or Determination of Tax Due into evidence under the certificate of the Director. Department Ex. No. 1. That document constitutes prima facie proof of the correctness of the amount of tax due. 35 **ILCS** 120/4. The Department's prima facie case is a rebuttable presumption. Copilevitz v. Department of Revenue, 41 Ill. 2d 154, 157, 242 N.E.2d 205, 207 (1968); DuPage Liquor Store, Inc. v. McKibbin, 383 Ill. 276, 279, 48 N.E.2d 926, 927 (1943). A taxpayer cannot overcome the presumption merely by denying the accuracy of the Department's assessment. A.R. Barnes & Co. v. Department of Revenue, 173 Ill. App. 3d 826, 833, 527 N.E.2d 1048, 1053 (1st Dist. 1988). Instead, a taxpayer must present evidence that is consistent, probable and closely identified with its books and records, to show that the assessment is not correct. Fillichio v. Department of Revenue, 15 Ill. 2d 327, 333, 155 N.E.2d 3, 7 (1958).

The first issue is whether the Department correctly calculated Doe's taxable gross receipts. In this case, the Department's calculation of Doe's taxable gross receipts translates into its determination of the selling prices of the used cars Doe sold to others at retail. 35 **ILCS** 120/1 (definitions of "sale at retail," and "gross receipts"). For each such sale, Doe was required to file a separate transaction return on which he accurately reported "the consideration for [the] sale valued in money …." 35 **ILCS** 120/1, 120/3; 86 Ill. Admin. Code § 130.540. The parties do not dispute that Doe filed separate returns for each transaction; the Department, however, determined that Doe did not report the true

selling prices of the cars he sold on the returns he did file. Department Ex. 5, p. 2 (a memo from Sagum to his supervisor).

Taxpayer first complains that the Department's audit was flawed because it was begun two years after he ceased doing business, at a time when he no longer had complete books and records. Tr. p. 87 (closing argument). Section 7 of the Retailers' Occupation Tax Act ("ROTA") and Illinois regulations promulgated pursuant thereto, however, both provide that retailers must keep their books and records for three years after the period for which they were created, unless the Department notifies them that they may dispose of them earlier. 35 **ILCS** 120/7; 86 Ill. Admin. Code § 130.815(c). Doe presented no evidence that the Department notified him that he could dispose of his books and records prior to its audit. The Department's audit, therefore, was not flawed because it was conducted after taxpayer ceased operations. Rather, the Department was required to use the best information available to it only because Doe failed to keep and/or maintain complete and accurate records for his own business during the time required by law.

Doe also argues — and attempted to show at hearing — that the Department's projection produced erroneous results because it was premised upon evidence from a single transaction. Tr. pp. 48-52 (Sagum), 88 (closing argument); Department Ex. 3. But Sagum did not base his projection solely on one purchaser's statement that he agreed to pay more for the car he purchased from Doe than Doe reported on the return for that one transaction. Department Ex. 4. He also decided to project a level of underreporting because Doe's own books and records showed that, on 30 separate occasions throughout the audit period, ABC's contracts showed a selling price that was much greater than the

one Doe reported on the transaction returns he filed regarding those sales. Department Ex. 4; Tr. pp. 33-34 (Sagum). And despite taxpayer's objection to the Department's audit methods and conclusions, counsel for taxpayer conceded that, when Doe believed that all he would receive from a purchaser for a vehicle was his down payment, Doe filed returns reporting only that amount as the selling price. *See* Tr. p. 88 (closing argument). Thus, nothing in this record establishes that the Department acted unreasonably when it determined that Doe underreported the selling prices of the cars he sold at retail during the audit period.

Moreover, Doe misapprehends the nature of the credit he suggests he was due because of his customers' alleged defaults on car payments. Used car retailers are required to report as the selling price of an auto the "consideration for a sale valued in money …." 35 **ILCS** 120/1. The selling price to be reported, moreover, is to be fixed as of the date of the sale — not in hindsight — with the only allowable deduction being the value of whatever trade-in a purchaser gives to the retailer. 35 **ILCS** 120/1; *see also* Keystone Chevrolet Co. v. Kirk, 69 Ill. 2d 483, 488, 372 N.E.2d 651, 653 (1978) (rebate from a car manufacturer to a purchaser after a sale at retail may not be deducted from the retailer's selling price).

During the time of the audit (and currently), retailers were (and are) entitled to file a claim for a refund for ROT previously paid regarding gross receipts realized from the sale of a vehicle later repossessed because of a purchaser's default on a financing agreement. *See* Form ST-557. Before December 2000, refunds of tax previously paid regarding the gross receipts from such sales were authorized, but only to the extent that the dealer had a "with recourse" agreement with whatever financing agency loaned the

purchaser the money to pay for the car at the time of the sale, and where a car had been repossessed by the financier. 86 Ill. Admin. Code § 130.1960(d) (1979-2000); Private Letter Ruling ST-2000-159 (July 31, 2000). Doe however, introduced no evidence that he had such an agreement with any such financing entity. Indeed, this record includes not one single written agreement of any kind that Doe used in his business during the audit period.

After December 2000, retailers who self-financed their own transactions were also entitled to file a claim for refund, once a purchaser's default had been written-off as a bad debt for federal tax purposes. 24 Ill. Reg. 18376; 86 Ill. Admin. Code § 130.1960 (eff. December 1, 2000). Thus, and both before and after December 2000, the refund expressly authorized was not a deduction to be taken by the retailer on the original transaction return. Rather, the claim had to be filed by taxpayer after the full amount of tax had been paid, and in the latter case, only once the purchaser's default could be documented by a bad debt write-off as reported on the taxpayer's federal income tax return. 86 Ill. Admin. Code § 130.1960(d) (effective December 1, 2000).

Essentially, Doe's argument is that in every case where he entered into an agreement to sell a car to a purchaser for a selling price that was greater than the selling price he reported on a transaction return, the car was either towed or repossessed, and the purchaser, thereafter, defaulted on all payments to Doe. Counsel for Doe makes these arguments, however, without offering a single copy of any financing agreement between himself and any customer, or between a customer and some other financing entity. Similarly, counsel argues that he tendered to the Department 163 vehicle titles that Doe had never transferred to purchasers, allegedly because the purchasers defaulted on their

payments. Tr. pp. 43 (Sagum), 89 (closing argument). He also argues that he gave the Department documents showing that certain vehicles were towed and/or impounded by certain entities. Tr. pp. 44 (Sagum), 89 (closing argument). Despite these arguments, no such evidence was offered at hearing. What those documents might have established, therefore, cannot be discerned from this record. Counsel for Doe, finally, introduced no documentary evidence to show how much money he actually received from any one purchaser, let alone all 406 purchasers, during the audit period. In sum, counsel argues that Doe was entitled to deductions from the actual selling prices of the cars he sold — deductions that are nowhere authorized by Illinois law — and in amounts that are not supported by any documentary evidence offered at hearing. Since a taxpayer's mere arguments cannot rebut the Department's prima facie case (Fillichio, 15 Ill. 2d at 333, 155 N.E.2d at 7), Doe's arguments must be rejected.

In the pre-hearing order, the parties identified the second issue as the propriety of the Department's use of documents seized during the execution of a search warrant issued to search a different taxpayer's business. *See* Pre-Hearing Order, dated June 10, 2002. The evidence admitted at hearing, however, adequately described the circumstances under which that particular seizure took place. The Department recovered ABC records while performing a judicially authorized search while investigating another taxpayer that conducted business at the location previously used by Doe to operate ABC. Department Ex. 5, p. 2. Doe, moreover, has not identified any cognizable harm attributable to the Department's use of the records seized. Since no person engaged in retailing enjoys the right to be absolutely free from audit, the Department's use of ABC's books and records here does not constitute a cognizable harm. *See* 35 **ILCS** 120/7;

People v. Floom, 52 Ill. App. 3d 971, 368 N.E.2d 410 (1st Dist. 1977) (ROTA's grant of power to the Department to inspect retailers' books and records includes the power to audit). Nor has Doe shown that he had any expectation of privacy in a location where he no longer conducted business. For all this record reveals, it may well be that Doe abandoned the records subsequently recovered by BCI agents. Perhaps most importantly, Doe never once alleges that the records seized do not accurately reflect the true selling prices of the cars he sold regarding the 30 transactions described by the recovered records. Thus, I find nothing improper about the Department's consideration of Doe's books and records here.

Although the parties identified only two issues in their pre-hearing order, at hearing, taxpayer also challenged the Department's fraud assessment, and the Department did not object to taxpayer's assertion of that issue. Section 3-6 of the Uniform Penalty and Interest Act provides, in part:

> Penalty for fraud.
> (a) If any return or amended return is filed with intent to defraud, in addition to any penalty imposed under Section 3-3 of this Act, a penalty shall be imposed in an amount equal to 50% of any resulting deficiency.
> * * * *

35 **ILCS** 735/3-6 (1994). The standard for determining whether a fraud penalty is appropriate is clear and convincing evidence. Puleo v. Department of Revenue, 117 Ill. App. 3d 260, 268, 453 N.E.2d 48, 53 (4th Dist. 1983). Circumstantial evidence is enough to support the imposition of a fraud penalty. Vitale v. Department of Revenue, 118 Ill. App. 3d 210, 213, 454 N.E.2d 799, 802 (3d Dist. 1983).

The factual bases for the Department's assessment of the fraud penalty are set forth in Sagum's May 10, 2001 memo to his supervisor (Department Ex. 5, p. 2), and

within Sagum's global taxable exceptions schedule. Department Ex. 4. Sagum wrote that memo to ask his supervisor to "render an opinion on the possibility of assessing civil fraud penalty …." Department Ex. 5, p. 2. In it, Sagum briefly related his audit methods. *Id.* He wrote that he compared the selling prices shown on the bills of sale included in ABC's seized documents with the returns as filed for those sales. *Id.* He also said that he compared the three responses he received from taxpayer's purchasers regarding the block sample period with the returns as filed. *Id.* Sagum wrote that, after making his comparisons, he determined that, for those 33 transactions alone, Doe underreported the sales by $35,116 and taxes by $2,292. *Id.*; *see also* Department Ex. 4. He also related that Doe collected such taxes from his customers, but did not turn those monies over to the Department. Department Ex. 5.

In response to this evidence, Doe never once disputes the key facts that support the imposition of a fraud penalty. Those facts are that, during the audit period, he regularly filed transaction returns that reported selling prices that were considerably less than the prices at which he agreed to sell cars to customers. While counsel for taxpayer argued that Doe's actions constituted negligence and not fraud, I cannot agree. The records recovered from Doe's former business location reflect transactions that spanned 1998, and every one of them shows that Doe materially underreported the true selling price on the return filed for that transaction. Department Ex. 4; Tr. p. 27 (Sagum). While those 30 transactions account for only a part of the 406 total transaction during the audit period (*see* Department Ex. 2), those were the transactions for which the auditor had the most, and the best, available information. *See* Tr. pp. 13-14, 34-35 (Sagum). I consider

those records more reliable than the three purchaser's memories of the details of the block sample transactions that Sagum took into account. *See* Department Ex. 3.

I agree that this record includes clear and convincing evidence that Doe consistently underreported the true amount of the selling price for his sales transactions. Department Ex. 4; Tr. p. 88. That evidence constitutes strong circumstantial evidence of an intent to defraud. 35 **ILCS** 735/3-6. Doe offered no evidence to show that his consistent, and admitted (by counsel, *see* Tr. p. 88) underreporting was due to negligence, rather than fraud. Finally, the evidence taxpayer *did* introduce, the testimony of BCI agent Richardson, did not tend to establish that the amounts Doe reported as the selling price on the business' transactions returns were true and correct.

Conclusion:

I recommend that the NTL be finalized as issued, with interest to accrue pursuant to statute.

Date: 12/12/2002

John E. White
Administrative Law Judge